No. 7826

In the United States Circuit Court of Appeals for the Ninth Circuit

California Barrel Company, Inc., petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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FILED

PAUL P. O'BRIEN

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CITATIONS

23781—35

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OPINION BELOW

The only previous opinion in the present case is that of the United States Board of Tax Appeals (R. 18–23), which is not reported.

JURISDICTION

This appeal involves income taxes for the calendar year 1927 in the sum of $14,915.65, and is taken from a decision of the Board of Tax Appeals entered November 8, 1934 (R. 24). The case is brought to this Court by petition for review filed January 29, 1935 (R. 24–36), pursuant to the pro-

visions of Sections 1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTION PRESENTED

Whether the petitioner corporation can utilize as a deduction in 1927 the net loss of its predecessor corporation in 1925 upon a showing that the business was the same and was reincorporated in order to comply with the local law.

STATUTE INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9:

> SEC. 206. * * *
>
> (b) If, for any taxable year, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called "second year"), and if such net loss is in excess of such net income (computed without such deduction), the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year (hereinafter in this section called "third year"); the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary. (U. S. C. App., Title 26, Sec. 937.)

STATEMENT

The facts as stipulated (R. 39–51, and as found by the Board (R. 18–23), may be summarized as follows:

All three corporations involved in the transactions hereinafter set forth were organized under the laws of California for the purpose of engaging in the manufacture and sale of barrels.

California Barrel Company (hereinafter referred to as "A" company) was organized in 1906.

California Barrel Company, Inc. (hereinafter referred to as "B" company), was organized on February 15, 1924, for a term of fifty years, with a capital structure of 9,000 shares of voting preferred stock of $100 par value each, and 9,000 shares of voting common stock of no par value, and on August 28, 1924, took over the business of "A" company.

On July 29, 1925, the Supreme Court of California in *Del Monte L. & P. Co.* v. *Jordan,* 196 Cal. 488, held that, pursuant to the State Constitution and Civil Code, the preferred and common shares of a California corporation must have the same par value. The Secretary of State thereupon refused to issue to "B" company the required statutory license to do business for the year 1926.

Under date of December 10, 1925, the "B" company sold certain assets transferred to it by "A" company (namely, stock of the Koster Products Company) at an alleged loss of $846,461.85, result-

ing in an alleged net loss of $504,572.66 for the taxable year 1925.

To provide a means for continuing the business during 1926, the "B" company caused to be organized on December 19, 1925, for a term of fifty years, the California Barrel Company, Inc. (hereinafter referred to as "C" company), the petitioner herein, which complied with the local law.

On December 31, 1925, all of "B" company's assets were transferred to "C" company. No steps were taken to dissolve the "B" company, and no decree of court dissolving the same has ever been entered.

In its return for the calendar year 1925, the "B" company reported a net loss of $504,572.66. The "B" company filed no returns for the years 1926 and 1927. In its return filed for the calendar year 1927, the "C" company (petitioner herein) claimed a statutory net loss deduction in the amount of $306,348.56 as a portion of the alleged net loss reported on "B" company's return for the year 1925. In determining the deficiency in controversy, the respondent disallowed such deduction on ground that the alleged net loss was not sustained by this petitioner. The Board approved this determination.

ARGUMENT

The power to tax income like that of the new corporation "C" is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace;

and only as there is clear provision therefore can any particular deduction be allowed. It is submitted that the question involved in this appeal is controlled generally by *New Colonial Co.* v. *Helvering,* 292 U. S. 435, and specifically by *McLaughlin* v. *Purity Inv. Co.*, 75 F. (2d) 30 (C. C. A. 9th).

In *New Colonial Co.* v. *Helvering, supra*, the Supreme Court pointed out (p. 440):

> The statutes pertaining to the determination of taxable income have proceeded generally on the principle that there shall be a computation of gains and losses on the basis of a distinct accounting for each taxable year; and only in exceptional situations, clearly defined, has there been provision for an allowance for losses suffered in an earlier year. Not only so, but the statutes have disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, i. e., to treat them as personal to him and not transferable to or usable by another.
>
> Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.

Section 206 (b) of the Revenue Act of 1926, *supra,* which governs the instant case, provides that a net loss of any taxpayer shall be allowed as a deduction in computing the net income "of the taxpayer" in the succeeding year. This provision is unambiguous. It has been held repeatedly that net losses are personal to the taxpayer and may be

applied only against the net income of the taxpayer in a succeeding year.

The question presented in the instant case is not in any essential particular different from that presented in *New Colonial Co.* v. *Helvering, supra.* Mr. Justice Van Devanter, in delivering the opinion of the Court, stated the question as follows (p. 437):

> The question presented is: Where all the assets and business of an older corporation are taken over by a new corporation, specially organized for the purpose and having substantially the same capital structure, in exchange for a portion of its stock, which is distributed by the older corporation among the latter's stockholders share for share, thereby retiring the old shares, is the new corporation entitled, notwithstanding the change in corporate identity and ownership, to have its taxable income for the succeeding period computed and determined by deducting from its net income for that period the net losses sustained by the older corporation in the preceding period? * * *

In construing the pertinent section of the statute, the Court stated that (pp. 440–441):

> Its words are plain and free from ambiguity. Taken according to their natural import they mean that the taxpayer who sustained the loss is the one to whom the deduction shall be allowed. Had there been a purpose to depart from the general policy in that regard, and to make the right to the

> deduction transferable or available to others than the taxpayer who sustained the loss, it is but reasonable to believe that purpose would have been clearly expressed. And as the section contains nothing which even approaches such an expression, it must be taken as not intended to make such a departure.

There, as here, the taxpayer contended that even though the section was not literally complied with, for all practical purposes the new corporation was the same entity as the old one and therefor the same taxpayer. The Court, in answer to this argument, stated that the case involved no such exceptional circumstances as to warrant the disregard of the separate entity of the corporation. On the contrary, the Court was of the opinion that the case was a typical one for the application of the separate entity rule, and concluded that the alternative contention had no legal basis.

In *McLaughlin* v. *Purity Inv. Co., supra,* this Court applied the principles enunciated in *New Colonial Co.* v. *Helvering, supra,* to a set of facts substantially identical with the case at bar. There, as here, the predecessor corporation was formed under the laws of California, with preferred stock having par value and common stock having nonpar value. Following the decision of the Supreme Court of the State of California in *Del Monte L. & P. Co.* v. *Jordan, supra,* the Commissioner of Corporations denied the corporation a license to

transact business, as was the situation in the case at bar. Thereupon, a new corporation was formed with a substantially identical stock structure to take over the assets and business of the predecessor corporation. The only difference between the two cases was that in the *Purity Inv. Co.* case the new corporation was chartered under the laws of Nevada instead of California. But this factual distinction clearly had no legal effect on the question involved. After quoting at length from the opinion of the Supreme Court in *New Colonial Co.* v. *Helvering, supra,* this Court said (p. 33):

> There is no fact in the instant case which takes it out of the rule laid down by the Supreme Court in the *New Colonial Ice Company* Case. The mere fact the predecessor California corporation was but a *de facto* corporation would not affect the situation. As such *de facto* corporation, it was entitled to enjoy the privileges of a corporation until action was brought by the Attorney General for dissolution. It had the power to convey, and did convey, its assets to another corporation organized for such purpose. Even though it was deemed desirable to have a stock structure with both par and non-par stock, and this could be accomplished only by a corporation organized in pursuance of the laws of another state, such corporation of necessity would be regarded "as a distinct corporate entity and therefore free from difficulties attending the old one." * * *

Thus, although its charter was defective, the predecessor corporation in the case at bar was a *de facto* corporation, a separate business unit within the contemplation of the law.

The alternative contention of the taxpayer, that the new corporation was substantially the same taxpayer as the predecessor corporation by reason of the identity of interest and continuity of business, was further met in the recent case of *Turner-Farber-Love Co.* v. *Helvering,* 68 F. (2d) 416 (App. D. C.), where the court, after concluding that the tax laws treat separate corporations as separate taxpayers and that the statute governing deductions confines the use of the loss to the txpayer who sustains it, made this pertinent statement (p. 417):

> Nor is the situation in this respect changed because in the transfer of assets from the one company to the other a continuing business is involved. The fact of separate identity still remains, and the rule that courts will look beyond the shadow to the substance, which petitioner invokes, is here no more applicable than it was in *New York, etc., R. Co.* v. *Burnet,* 62 App. D. C. 29, 64 F. (2d) 152, 154, where we said it is applied only in cases in which to refuse to apply it would be to countenance fraud.

In view of the premises, it is submitted that this Court could well agree with the conclusion reached by the Circuit Court of Appeals for the First Circuit in the closely related case of *Athol Mfg. Co.* v.

Commissioner, 54 F. (2d) 230, where the following conclusion was reached (p. 231):

> We fail to see how we can add anything to what was stated by the Board of Tax Appeals in its opinion. We are in full accord with its ruling and finding that the petitioner was an independent entity from the old corporation whose assets and business it took over; that the losses sustained by the old company in conducting its business during 1922 and a part of 1923 were not the petitioner's losses; and that it was not entitled to deduct the same in its tax return. * * * We can hardly see why this appeal was taken.

CONCLUSION

Since the petitioner corporation is not the same taxpayer as the predecessor corporation, it is not entitled to a deduction in 1927 for any portion of a net loss sustained in 1925 by its predecessor. The judgment of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted.

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OCTOBER 1935.

U. S. GOVERNMENT PRINTING OFFICE: 1935